PENALTY CLAUSES IN CONTRACTS – SPOTTING THEM AND AVOIDING THEM

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In this month’s Legal Matters we give you an overview of penalty clauses in commercial contracts.

If you are a party to a contract which has recently been breached by the other party, your first thought might be to go back to the contract and check what happens in the event of breach. If you spot a clause which provides for payment of a fixed sum to the innocent party upon breach of a particular term (without having to go to court), you might think you’re alright. But there’s a danger that, if the clause isn’t carefully drafted, it will be construed as a “penalty clause” and you won’t be able to enforce it.

WHAT IS A PENALTY CLAUSE?
A penalty clause is a term of a contract which seeks to impose a penalty or forfeiture as a consequence of breaching that contract or failing to perform an obligation under it. The object of damages for breach of contract is to compensate the innocent party for the breach rather than to punish the guilty party for the breach. Hence, a provision in a contract which causes the guilty party to suffer in such a way which cannot be justified by the breach is a penalty clause. Penalty clauses are unenforceable under English law.

PENALTY OR LIQUIDATED DAMAGES CLAUSE?
If the purpose of the clause in the contract is to act as a deterrent against breach, it is a penalty. If however, the clause was inserted into the contract as a genuine attempt by the parties to estimate in advance the loss which would likely result from the breach (at the time the contract was entered into), it is a liquidated damages clause. Liquidated damages clauses are a useful tool in commercial contracts and they are enforceable.

ENFORCEABILITY – WHY DO PENALTY CLAUSES MATTER?
Where the clause is a penalty, the court assesses damages in the usual way, looking at the actual loss to the innocent party. If the innocent party’s actual loss is less than the amount stated in the contractual clause, the innocent party would obviously want to rely on the contract. This would not be possible if the clause was considered to be an unenforceable penalty.

PRACTICAL TIPS FOR IDENTIFYING PENALTY CLAUSES
The following types of provisions are capable of being a penalty clause:
- A provision which requires the payment of a sum by a defaulting party.
- A provision which allows the innocent party to withhold monies.
- A provision which requires the transfer of assets from one party.
- A provision which is extravagant or oppressive.

However, if the provision can be commercially justified, and its predominant purpose is to compensate loss and not to deter breach, then it may not be a penalty clause.

If you require advice on penalty clauses, then please contact us on the Legal Helpline.

CASE STUDY
CAVENDISH SQUARE HOLDINGS -V- MAKDESSI (2012)

IN Cavendish Square Holdings -v- Makdessi, a dispute arose over a complex set of calculations relating to the purchase price for the transfer of shares in a large advertising and marketing communications company. The main question for the Court was whether or not certain provisions in the transfer agreement were enforceable or constituted penalties. Their Lordships decided that Cavendish had legitimate interests to be protected through the inclusion of those clauses and therefore they were not penalties.

In reaching their decision, the Court decided that the modern approach to the law of penalties requires the following questions to be asked:

1. Is there a commercial justification for the provision?
2. Is the provision extravagant or oppressive?
3. Is the predominant purpose of the provision to deter the breach?
4. Was the provision negotiated on a level playing field?

It is important to consider all of these conditions when applying the law of penalty clauses, but of course, penalty clauses are best avoided by ensuring the contract is carefully drafted in the first place.